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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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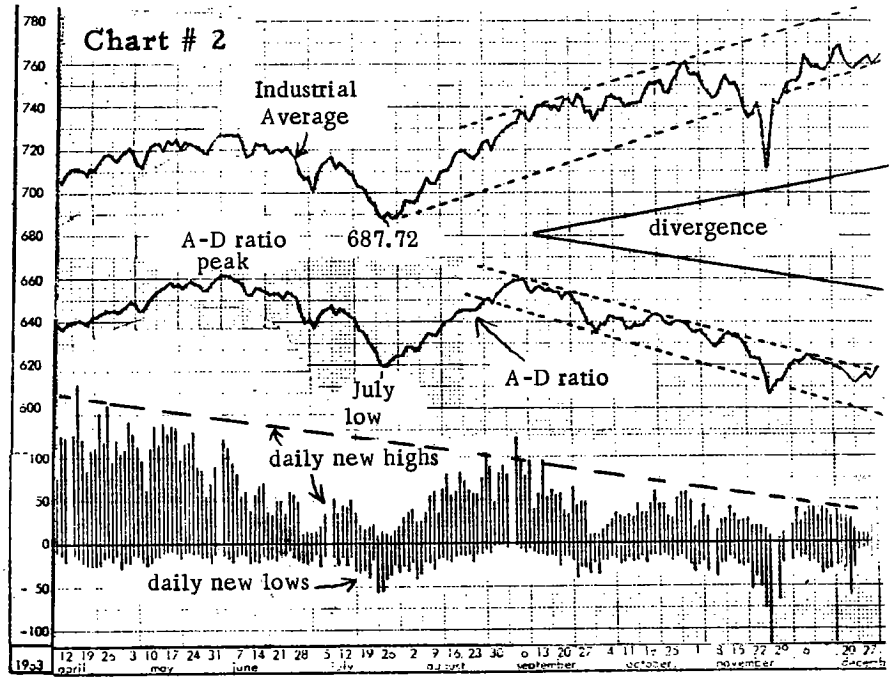
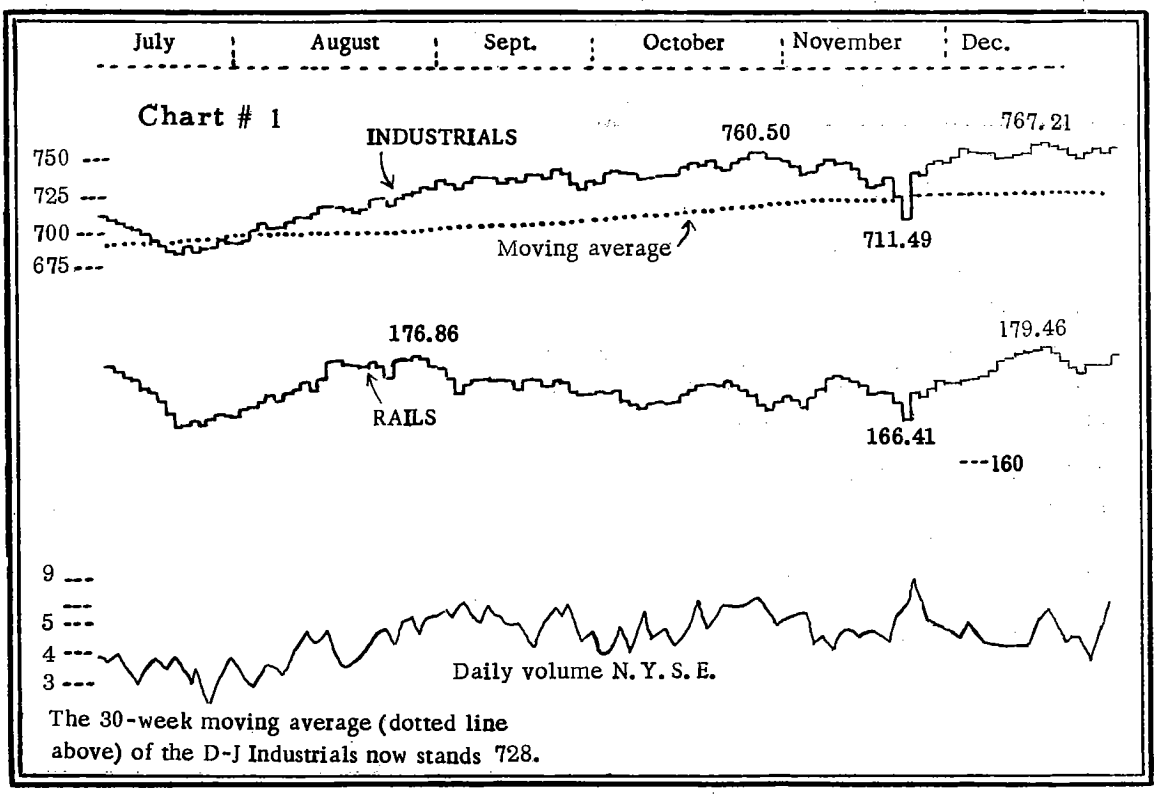
THE MARKET Since the initial recovery from the "assassination-panic" lows, the Rail Average has worked generally higher while the Industrials have moved within a rather narrow range (see Chart # 1). On December 18 the two Averages recorded highs of 767.21 and 179.46, respectively. Following a decline to minor lows established on December 24, the two Averages then rallied up to and through the last day of 1963. Considering that the market normally rallies during the last week of the year, the December 24-31 action might be labeled "par for the course". It is for this reason that most market students will be watching the early 1964 action for a truer indication of what to expect in the period ahead.

As far as the main body of stocks is concerned, the unhealthy divergence between the majority of issues (as measured by the advance-decline ratio) and the Industrial Average continues, and the A-D ratio is currently a slight distance above its November low (see Chart #2). Daily new highs have dwindled to the 10-40 range, and in view of the fact that the Industrial Average is now within 1% of its all-time high, this must be classified as a decidedly negative feature of the market. The decomposition in market "breadth" is dramatized in the latest report by Joe Granville of New York: he notes that as of December 24, 685 N.Y.S.E. issues were within 1 to 3 points of their 1963 lows. In other words, almost half of the Big Board issues are currently around their lows for the year. Is it any wonder that 1963 has been an unprofitable year for many investors?



THE YEAR 1963: From the standpoint of the market student, 1963 turned out to be pretty much of a "bore". As seen on Chart #1 (which is scaled to semi-logarithmic proportions and measures percentages), 1963 produced little in the way of dramatic movement one way or the other. During December, 1963, the two Averages did push to new highs — Industrials to approximately 4% above their 1961 peak, and Rails to within a few points of their 1956 peak. But in terms of percentages, the upside action was of minor proportions.

Apart from the Averages, the advance-decline ratio "topped out" in late May, 1963, and this meant that the majority of stocks advanced through the first quarter of the year but moved sideways or sagged during the second,



The 30-week moving average (dotted line above) of the D-J Industrials now stands 728.

third and fourth quarters. For this reason, the average investor made little or nothing in the market after May, 1963. And (except for the American Exchange, which declined continuously) there was not even enough solid downside action during the last three quarters of 1963 to make it a particularly interesting year.

MY BET FOR 1964: My bet is that 1964 is going to make up in drama and action for what 1963 lacked. I say this for a number of reasons. First, the A-D ratio (as explained above) struck its 1963 peak in May, 1963, while the Industrial Average continued to establish new highs through December. In the past, when the A-D ratio has recorded its peak in the first half of the year while the Industrial Average has gone on to record further (unconfirmed) highs during the second half — important trouble has ensued (during the following year). The recent record of this type of action appears below.

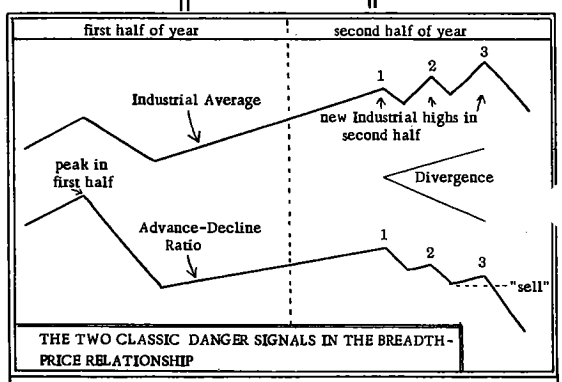
1956-57: The A-D ratio established a peak in March, 1956, while Industrials recorded their peak in April of that year. A decline followed — then a rally into August, 1956. In August, Industrials rose to within a fraction of a point of the April peak, but the A-D ratio lagged badly. This process was repeated in April, 1957. In the July-October, 1957, period, trouble came. Industrials dropped 20% in a matter of three months.

1959-60: The A-D ratio recorded its high in the first half (March) of 1959, while Industrials rallied to new (unconfirmed) highs during the second half (August and again in December). The Industrial peak was struck on January 2, 1960, and from there a broad decline took the senior Average to an October, 1960, low of 566.05 (119 points below the January peak).

1961-62: The A-D ratio recorded its peak in the first half (May) of 1961, but Industrials extended their solo advance into the second half of the year, establishing new highs in August and again in December. What occurred the following year (i.e., in 1962) is too fresh in our minds to need repeating.

THE PRESENT CASE: The A-D ratio struck its 1963 high during the first half of the year (May), but we witnessed new Industrial highs through the second half of 1963. On September 5, 1963, a definite divergence between Industrials and the A-D ratio began (see Chart #3), and thus we are currently caught in the grip of the two bearish breadth-price possibilities: (1) an early peak on the A-D ratio followed by new (unconfirmed) highs in the Industrial Average during the second half of the year, and (2) a full divergence between the A-D ratio and the Industrial Average.

Chart # 3



THE TWO CLASSIC DANGER SIGNALS IN THE BREADTH-PRICE RELATIONSHIP

The first danger signal is illustrated as breadth (the A-D ratio) records its annual peak in the first half of the year while the Industrial Average goes on to establish successive (unconfirmed) highs during the second half of the year. The second danger signal is a full breadth-price divergence as signified by the successive peaks labeled 1, 2 and 3 on chart. Both indicators record highs at point 1. At 2 Industrials rise to a new high but at 2 the A-D ratio falls to better its own preceding peak at 1. The process is repeated at peak 3, following which both indicators turn down. The divergence is completed and a "sell-signal" is given when (following point 3) the A-D ratio breaks to a new low as shown on chart.

The major technical disorders described above favor an important decline to begin sometime in 1964. "Not so fast," objects the bull; "how about the current record short interest, a position which has been expanding for five consecutive months? What about the fact that the odd-lotters have been selling all during 1963? What about the fact that Industrials and Rails rose to new highs together during December, 1963? These are hardly signs that one normally associates with a major decline."

And the bull's objections cannot be lightly dismissed. I have given a good deal of thought to the above stated problems, and I believe that three approaches should be discussed. In other words, the current breadth-price divergence is an accomplished fact, but there are three major courses of action which the market can take in the face of that fact.

POSSIBILITY NUMBER ONE: It is possible that the huge short interest, the many months of odd-lot selling, the confirmed highs in the two Averages, are the "foolers" which are going to cost today's professionals dearly — just as the gigantic (and bullish-appearing) rise of 1930 proved costly to professionals of thirty-three years ago. This is one possibility and not a pleasant one. It implies that the market could collapse at any time.

POSSIBILITY NUMBER TWO: Suppose the market turns decidedly weak during early 1964. And suppose we have a drop of say one hundred points — a drop which takes the Industrial Average back to the 650 area. Such a decline might serve to change the attitude of today's market followers from a state of hesitancy to a state of extreme bearishness.

A first quarter decline to the 650 area would give us a heavily "oversold" market, and a market with perhaps an even larger short interest. It would put the A-D ratio back "in gear" with the Industrial Average on the downside; it would shake out the last of the odd-lot public; it would result in margin calls for many weaker speculators. Then, just as Wall Street was about to "throw in the sponge" on 1964, we could have the final upside "blow-off". That last reversal and upward rush could conceivably bring in the public it could conceivably arouse interest in many ("bargain") low-priced issues and Amex issues, it could conceivably bring in volume of 6-9 million shares per day.

In this writer's opinion, the market has been growing progressively more "tired" since late 1959 (as suggested by the progressively poorer breadth during each major advance). Perhaps, in order to obtain a final surge and climax to the great post-war market, we

need the strongest technical position possible — which means a year-and-a-half of odd-lot selling, the highest short interest on record, and a frightening decline just prior to the final push. The foregoing, of course, is all very theoretical — but I consider it a possibility during what I expect will be a violent 1964.

POSSIBILITY NUMBER THREE: And what about the final possibility — that the Averages might push up directly from here, with Industrials rising into say the 800 area? This, to my mind, would be the most dangerous move of all; it would simply mean that the ominous breadth-price divergence was continuing. The technical vacuum between the Industrial Average and the A-D ratio would be growing greater, and the pressures to fill the vacuum growing stronger. A direct rise from current levels would correspond (technically) to the final push in 1929; it was this possibility which was discussed in detail in Letter 239. Needless to say, I would not advise subscribers to follow the market if the Averages extend their rise into the first quarter of 1964.

QUESTION: "You use the name "Dow Theory" in the title of your Service and you call yourself a Dow Theorist. Yet a large portion of your Letters deal with matter other than the Dow Theory. Please explain." (D.G.R. — Yuma, Arizona).

ANSWER: To begin with, I believe that most people harbor major misconceptions regarding the Dow Theory and what it is. Dow's original writings dealt to a great extent with values, the determination of values, and with the movements in the market which take stocks alternately to inflated levels of overvaluation and then to depressed levels of undervaluation.

Dow seldom mentioned the Averages themselves; he was more concerned with Wall Street and public psychology and the alternate periods of depression and optimism which brought on those periods which he referred to as "panics" and "bull markets". Hamilton and Rhea placed a good deal more emphasis on the actual interpretation of the Averages. Nevertheless, neither of these men ever lost sight of basic market fundamentals as demonstrated by Hamilton's prophetic editorial of April 5, 1929, entitled "A Test of Values". Readers might note that this editorial was written at a time when there was nothing in the Averages to imply trouble ahead. That editorial ended with the following question: "The student should ask himself if stocks are not selling well above the line of values, if people are not buying upon hopes which may be at least deferred long enough to make both the heart and the pocketbook sick." That warning based on values came true. The "hopes" were deferred in some cases for as long as a generation before certain stocks returned to their 1929 levels. Many other issues, of course, never did survive the 1930's.

Regarding the theme of values, the greatest Dow Theorist of the 1930's, Robert Rhea, wrote: "I have always regarded 'investing' in stocks to mean acquiring equities of sound values in times of depression and holding for both dividends and appreciation until prices have exceeded a line of reasonable values before selling." Again the word "values" is used.

From all this it follows that the student with a knowledge of values and sufficient patience should wait for the periods of depression to buy and wait for the periods of "well being" and overvaluation to sell. "But times are different," says the reader of today. "Dow never envisioned massive Government intervention, a Federal Reserve Board, world-wide planned inflation, an F.D.I.C.. There won't be another era of depression in our lifetime."

"When prices are up and the country is prosperous," wrote Dow, "It is always said that while preceding booms have not lasted, there are circumstances connected with this one which make it unlike its predecessors and give assurance of permanency. The one fact pertaining to all conditions is that they will change."

If I did not believe the above, I would change the title of these Letters and delete the name Dow Theory. Nevertheless, it is true that a condition of overvaluation has lasted now from late-1958 to the present; this in itself is unique and a condition which never confronted either Dow or Hamilton. It is this long period of overvaluation which has forced a departure from strict Dow Theory interpretation, and it has also heightened the need for refinements and more sensitive indicators of trend analysis. Beyond all the technical market tools, however, this writer still gives the greatest emphasis to the precepts of Dow's classic Theory.

It should be remembered that Dow Theory cannot give an exact interpretation of the state of the market at any given time. Those who relied on the confirmation of the Averages principle in 1929 (while ignoring the principle of values) were doomed to disappointment. Those who refrained from buying on the last downward penetration in June, 1949 (while average yields on the Dow were a whopping 7.9%) also had cause for regrets. At present, if the Dow Theory is telling us anything I believe it is saying that it is late in the game and that stocks are both "tired" and overvalued. With such conditions prevailing, the market student has his choice of waiting for the next major period of undervaluation or trading the major swings to the best of his ability. I have and will continue to try to satisfy both needs.

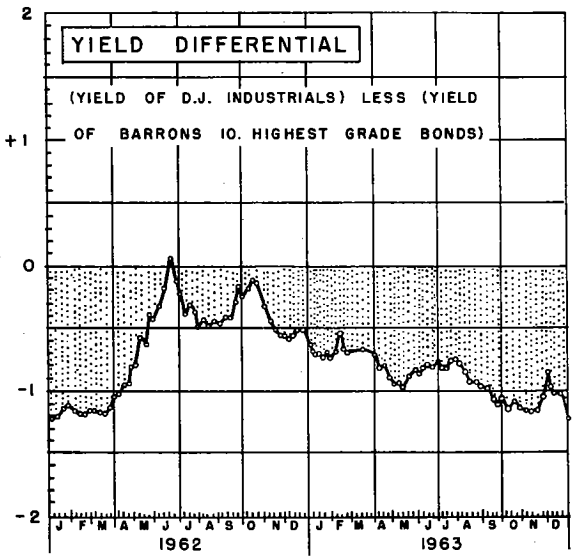
SUNDRY COMMENTS: Mr. Humphrey Neill of "Contrary Opinion" fame starts his latest bulletin as follows: "Can you recall a year-end when the news and the forecasts were boomier?" He lists two topics which seem to appear "in every newspaper and magazine you pick up." First, President Johnson's political wizardry, and his certain nomination and election in 1964. Second, the assurance of a boom in the economy when the new tax bill passes (and it is thought certain to pass).

Against this rosy set of predictions, it is interesting to note that the Geisinger Indicator (680 West End Ave., N.Y.C. 25), an index which has had an amazing record of successfully predicting the trend of the Federal Reserve Board Index of Production, has turned distinctly "luke-warm" for the first quarter of 1964. With the wide-spread expectation of an accelerating boom during 1964, it

would take only a mild economic downturn or even a leveling-off to send the stock market lower. Perhaps the majority of stocks are forecasting just such an event as they currently hold below earlier levels (as per the A-D ratio). The first quarter of 1964 shapes up as a fascinating one — with perhaps a fooler or two.

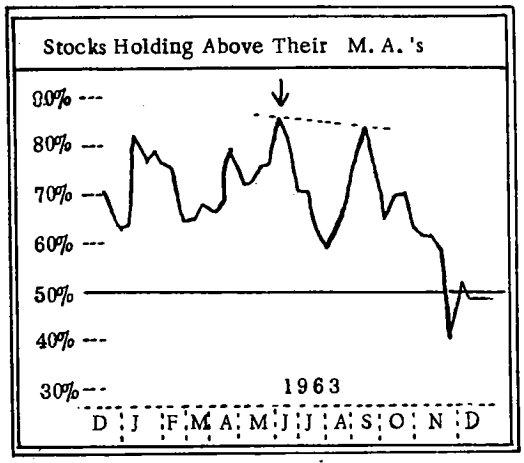
Another feature of the market which has caused me to do a good deal of thinking: the A-D ratio on the American Exchange and Barron's Low-Priced Stock Index both "topped out" in March, 1959. Both indicators dropped precipitously to late 1960 lows, then rallied to mid 1961. Since then, the trend of these two indicators has been down. In other words, the major trend of speculative and low-priced stocks has been down for almost five years, while the last good rally in this sector of the market occurred three years ago (in early 1961). Three years is a long time between major rallies, and I believe the time is approaching when we can logically expect another important rally in speculative issues (even if the major trend continues down). Both of these important and potentially profitable groups will bear close watching during 1964. I feel that there is a good rally coming up in the speculative sector of the market — but it could come after a sharp market correction.

CHART OF THE WEEK: The accompanying chart illustrates the negative differential between the yield on the D-J Industrial Average and the yield on Barron's 10 Highest-Grade Bonds. The negative spread is now the greatest in two years, and it currently matches the negative spread which existed in the first quarter of 1962. The chart is saying that the buyer of the highest-grade bonds now receives a return of 4.39% while the buyer of typical high-grade industrial stock receives a return of 3.1%, a spread of 1.28% in favor of the bond-buyer. The negative spread seldom goes higher than this without a correction. This, by the way, is a fundamental study in "values". (Chart courtesy of Merrill Analysis, Box 228, Chappaqua, New York).


YIELD DIFFERENTIAL
(YIELD OF D.J. INDUSTRIALS) LESS (YIELD OF BARRONS 10. HIGHEST GRADE BONDS)
2
+1
0
-1
-2
J F M A M J J A S O N D J F M A M J J A S O N D
1962
1963

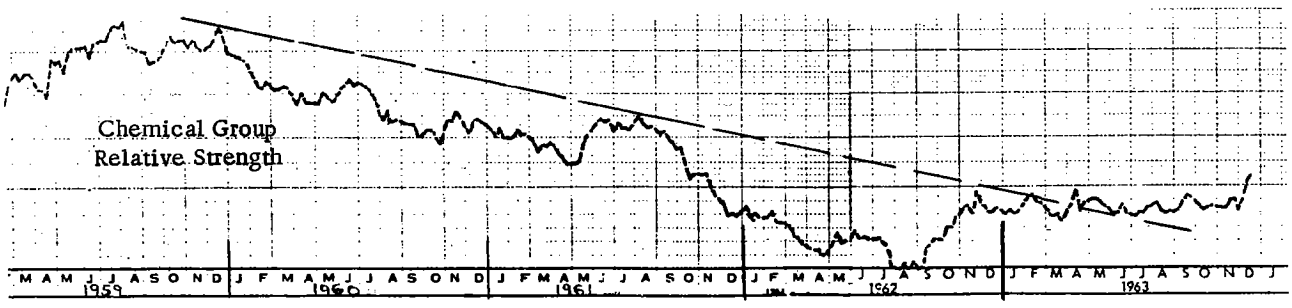
STOCKS (see small chart below) Of 432 stocks which are tabulated here weekly, 207 or 48% are now holding in a bullish position above their 200-day moving average. This represents no change from last week, and the study is bearish in that the indicator is below the 50% level.

Against this broad picture of the general market, my friends at Chartcraft, Larchmont, N.Y., currently tabulate the 30 D-J Industrial stocks as 67% bullish, 37% bearish. The only bearish Dow stocks are Alcoa, Amer. Can, Amer. Tobacco, Anaconda, Goodyear, Johns Manville, Standard of Calif., United Aircraft, U. S. Steel, and Westinghouse. Again, we see a picture of confusion and divergence.



One of the outstanding characteristics of this market is as follows: you pick five stocks which look strong, appear to be under accumulation, have a good "story". A month later four out of the five are below the prices at which you found them attractive. Recent issues which "looked" interesting and which fall into this catagory, for instance, are Case, General Telephone, Bucyrus Erie, Goodyear, Addresso-Multi, Emerson Radio. This type of "two-steps forward, three-steps backward" performance was last seen during 1961. I associate it with a market under distribution. As soon as a stock gives the appearance of strength and develops a little volume, someone uses that "strength" as an opportunity for unloading.

At the bottom of the page is a five-year relative strength chart of the Chemical Group. This chart represents the most important change in group relative strength of the past month. Note that the Chemical Group turned down in popularity in late 1959 and this trend continued until mid-1962. Over the past year Chemicals have acted about the same as the market, as far as relative strength is concerned. But during the past two weeks the group has turned decidedly stronger than the market. I consider this group one of the most favorable at present.


Chemical Group
Relative Strength
M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J
1959
1960
1961
1962
1963

What Are The Low-Priced Stocks Actually Doing? I have included twelve charts (weekly price movements) of typical low-priced stocks. These are true low-priced issues — not to be confused with the "new issues" of a few years ago. These twelve stocks have been around a long time; they are probably here to stay. They are stocks which characteristically "make their upward move" during the latter stages of a bull market. When these issues "top out", they usually stay "out" and down for a long, long time. I picked these twelve stocks at random although five of them happen to be compenents of Barron's Low-Priced Stock Index. I believe these twelve stocks are representative of the whole speculative group on the N. Y. S. E. (the low-priced issues on the Amex, however, have not fared as well as the low-priced Big Board issues).

The top three stocks, Curtis, Walworth and Briggs appear to be in various stages of bullish trends, although Curtis is doubtful and may be forming a "double top". The middle six issues from Welbilt to Hupp could well be in "basing formations", and this is most interesting. If true it means that the majority of low-priced issues are at or near an accumulation phase. The bottom three stocks are in bearish trends, although Babbit is obviously either near its bear market bottom or on the verge of going out of existance.

To sum up, this is the low-priced stock picture: one-third of these issues are now in bullish trends, two thirds of the issues (following substantial declines) are now moving sideways or gradually down, and one-third are still in clearly bearish trends. I believe this jibes with my opinion regarding a possible important move in low-priced issues as stated in the "Sundry Comments" section of this Letter.

* * * *

Impressive chart patterns have been noticeably scarce over the past six months. But two stocks which have now formed large ascending triangles are International Nickel and Colorado Fuel and Iron. The ascending triangle is a classic accumulation pattern, implying a series of rallies and declines with each decline terminating at successively higher levels (thus, the ascending lower trendline). Finally, the entire "floating supply" of stock is absorbed, and the price breaks above the upper trendline. Note that Nickel has not only formed an impressive base but has reversed a relative strength line which has been in a declining trend since mid-1961.

Chart # 2, Chemical Group relative strength chart and Int. Nickel chart courtesy of Traders Research, 1431 Pearl Ave., Alton, Illinois 62003. Low-priced stock charts and chart of Colo. Fuel courtesy of Quote Digest, 110 N. Lorraine, Wichita Kansas.

In closing, may I wish all my subscribers a most happy and healthy 1964.